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Supreme Court of the United States

October Term, 1959

No. 553

LA GLORIA OIL AND GAS COMPANY and LA GLORIA CORPORATION, a Dissolved Texas Corporation, *Petitioners*

v.

FRANK SCOFIELD, Formerly Collector of Internal Revenue, First District of Texas, *Respondent*

PETITION FOR REHEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BINFORD ARNEY
721 Wilson Tower
Corpus Christi, Texas

TARLTON MORROW
CLYDE L. WILSON, JR.
VINSON, ELKINS, WEEMS & SEARLS
Esperson Building
Houston 2, Texas

Attorneys for Petitioners

Alpha Law Book Co., 402 Main St. Bldg., Houston 2

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La Gloria Oil and Gas Company and La Gloria Corporation pray that this Court grant rehearing of its order of January 11, 1960, denying the petition for a writ of certiorari, U.S. , and that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit in the above-entitled case as prayed for in the petition filed November 30, 1959, herein.

Reasons for Granting Rehearing and Issuing the Writ

The decision of the United States Court of Appeals in the instant case in failing to differentiate between the vital basic facts of non-production by the taxpayer in the casinghead plant case of *Helvering v. Bankline Oil Co.*, 303 U.S. 362, and in the vital basic facts of production by the taxpayer in this cycling case (and in erroneously concluding that this case is conceptually close to and controlled by Bankline), results in the Court of Appeals deciding an important question of federal law (with reference to the right of the statutory depletion deduction in connection with the production of heavier hydrocarbons by the relatively new cycling process) which should be settled by this Court.

The instant case is distinguishable in principle and in all material respects from the casinghead gasoline plant case of *Helvering v. Bankline Oil Co.*, supra. With respectful deference to the Court below, the majority's concept or mental image of the instant case as being close or similar or undistinguishable from Bankline is but a mirage phenomenon which can be produced only by overlooking the differentiation of the questions presented and the basic facts in the respective record of the two cases.

The Bankline case arose against the background of *Brea Canon Oil Co. v. Commissioner of Internal Revenue*, 77 F. 2d 67, Circuit Court of Appeals, Ninth Circuit, wherein the taxpayer, the owner of the wells which produced casinghead gas and the owner of a casinghead gasoline plant, contended that it is the gross income derived from the sale of casinghead gasoline rather than the market value of the wet content of the gas at the well which

should be used as a basis for the depletion allowance. There was no issue before the Circuit Court as to the taxpayer having an economic interest or as to his right to an allowance for depletion. The problem was to determine the depletable base. The Circuit Court held that it was the market value of the net product (value of the gasoline content of the wet gas) at the well that constitutes the depletable base.

In Bankline, taxpayer represented itself as being a casinghead gasoline manufacturer, that it obtained its supply of wet gas pursuant to casinghead gas purchase contracts with oil producers whereunder taxpayer paid to the producers 33-1/3% of the gross proceeds derived from the sale of casinghead gasoline extracted from the wet gas. Taxpayer offered evidence showing that in the tax years in question (1927, 1928, 1930) the prevailing rate of royalties or price paid for casinghead gas by other purchasers was higher than that paid by taxpayer under its contracts. Taxpayer contended that since it was paying less under its contracts at the old prices than the fair market value of the wet content of the gas during the tax periods in issue, it had the right to statutory depletion on the amount of the difference.

The Circuit Court of Appeals, Ninth Circuit, in *Bankline Oil Co. v. Commissioner of Internal Revenue*, 90 F. 2d 899, devotes a great portion of its opinion in discussing the evidence that the royalty rate or prices paid by taxpayer for the wet content of the casinghead gas were less than the prevailing prices then being paid under similar contracts. The Circuit Court found an economic interest apparently on the basis of the difference in the price paid by taxpayer and the then prevailing prices under other contracts, for the Court concludes:

> "As we have pointed out, the evidence in the case all tends to show that by reason of the change in royalty rates the petitioner had a definite economic interest in the oil in place upon which it was entitled to an allowance for depletion."

The Circuit Court remanded the case to the Board of Tax Appeals for a determination of the depletable base. However, this Court granted writ of certiorari, 302 U.S. 675. The Question Presented in the Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit filed in this Court by Bankline Oil Co. reads as follows:

> "Taxpayer, a casinghead gasoline manufacturer, engaged in processing wet gas into gasoline and dry gas obtains its supply of wet gas by contract with oil producers. Is the taxpayer entitled to an allowance for depletion of gas in place because the contract price which it paid for wet gas is below the market price at the time of delivery of the wet gas to the taxpayer by the producers?"

It is self-evident from the Petition filed by Bankline in this Court that the taxpayer there was asserting no contention that it made any essential contribution to production sufficient to give it an economic interest in the minerals in place. Under the "Statement" in Bankline's Petition the taxpayer says:

> "Under the contracts (R. 76-115) the taxpayer took no part in the production of the wet gas, conducted no drilling operations upon any of the producing premises, did not pump oil or gas from the wells. * * *."

It is inescapable that Bankline considered that the production of the crude oil and casinghead gas had been completed at the mouth of the well, that it there purchased such casinghead gas as was produced by the oil producers, that it admitted it took no part in the production of the casinghead gas, that it was asserting a claim for the depletion allowance because under its purchase contracts executed in prior years it had obtained an economic advantage consisting of the difference between the lower price which it paid for the wet gas under its contracts and the fair market value of the wet gas at the mouth of the wells in the tax years in issue.

Chief Justice Hughes in the opinion of this Court places his finger on the salient point when after reciting Bankline's contention that it was entitled to deduct for depletion 27½% of the difference between the price paid for the wet gas and its fair market value (P. 366), and after reviewing the fundamental purpose of the statutory allowance (P. 367), says "It was not engaged in production" (P. 367). Then in disposition of the issue before the Court the opinion says:

> "Whether or not the wet gas had a market value and, if it had, whether that value was greater than the amount respondent paid, is in no sense determinative."
>
> * * *
>
> "The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance." (303 U.S. 368)

The La Gloria case arose against the background of *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, the latest pronouncement of this Court upon the "eco-

nomic interest" concept with reference to the minerals oil and gas. This Court was there called upon to decide whether the contribution of the use of the land of the upland owners for drill sites in return for rental based on a share of the net profits constituted an economic interest in the oil in place, and this Court stated:

> "It is true that the exclusive right to drill was granted to Southwest and it is also true that the agreements expressly created no interest in the oil in the upland owners. But the tax law deals in economic realities, not legal abstractions, and upon closer analysis it becomes clear that these factors do not preclude an economic interest in the upland owners." (P. 315)

The upland owners by making an essential contribution to production by furnishing drill sites for rental based on a share of net profits were held to have an economic interest in the minerals in place, this Court said:

> "This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases." (P. 316)

The mineral subject matter of the La Gloria case involves and is limited to the production of the heavier hydrocarbons (approximately 5% to 6% of the volume of the natural gas in high pressure gas reservoirs) by means of the cycling production process. The requisites of producing these heavier hydrocarbons were stipulated by the parties and comprise a vital part of the record now on file with this Court. Quoting from Paragraph 22 of the Stipulation (R. 44-46) we find:

" * * * Under the conservation laws of the State of Texas, in the absence of an available market for the methane hydrocarbon compounds, the production of natural gas from the La Gloria Field and the separation therefrom of the heavier hydrocarbon compounds, followed by the flaring of the residue gas, that is the lighter methane hydrocarbon compound, would have been deemed to have constituted physical waste and would not have been permitted. The then existing only feasible means of obtaining an economic return from the natural gas reserves was a method of separating the marketable heavier hydrocarbon compounds from the natural gas and then returning the remaining residue or lighter hydrocarbon compounds to the gas producing formations and reservoirs underlying the lands covered by the leases. Such existing feasible and efficient means involved the establishment of adequate natural gas reserves, the construction and operation of a natural gas processing or separation plant, the construction and operation of gathering lines and return lines, the existence of necessary producing gas wells and input gas wells, and the construction and operation of requisite compressors and other facilities for compressing the residue gas to a pressure in excess of that existing in the gas producing formation. The operation of these facilities involves producing the heavier hydrocarbon compounds by means of gas wells, gathering the gas through gathering lines to a plant, separating the heavier hydrocarbon compounds therefrom in such plant, compressing the residue gas, and returning the residue gas through return lines to input wells, the injection of such gas through input wells to producing formations, the maintenance of pressure in the reservoir, and the forced flow of migration of heavier hydrocarbon compounds toward the producing wells." (R. 44-46)

In light of the foregoing stipulation it is apparent that requisite factors to produce the heavier hydrocarbons con-

sisted of establishment of adequate reserves, producing wells, input wells, and construction and operation of gathering lines, return lines, cycling plant facilities, and compressors. La Gloria made essential and indispensible contributions to production and engaged in the production of the heavier hydrocarbons, all in return for a share of the heavier hydrocarbons produced.

Pursuant to and consistent with the latest pronouncements of an economic interest concept by the Supreme Court in *Commissioner v. Southwest Exploration Co.*, supra, the contribution of La Gloria, namely:

(1) the drilling at its sole expense (subsequently recoupable only from proceeds of production) of requisite producing wells to establish adequate gas reserves and adequate daily deliverability and requisite input wells;

(2) the furnishing of a plant site and the construction at its sole expense of cycling facilities essential for gathering gas from the well heads to the plant, essential for the production and recovery of the heavier hydrocarbons, essential for the compression of the residue gas to a pressure in excess of that contained in the high pressure reservoirs, essential for the return of the residue gas to the input wells, and the inter-connection of such facilities to the producing and input wells;

(3) the exclusive dedication of the contract specified capacity of such plant to the participating area; and

(4) the operation at its sole expense of the cycling plant facilities during the life of the leases (subject only to a right to salvage the plant if the daily volume of gas diminished below a specified

> minimum quantity and a right to refrain from processing gas containing less than a specified minimum GPM content of the heavier hydrocarbons) for the production and recovery of the heavier hydrocarbons, for the compression of the residue gas, and for the return of the dry residue gas to the input wells for injection by means of such compression into the producing horizons, which injected dry gas swept the wet gas containing the heavier hydrocarbons toward the producing wells and enabled the production and recovery of millions of barrels of heavier hydrocarbons that without the resultant maintenance of pressure in the reservoir would have been irretrievably lost by retrograde condensation;

all in return solely for a share of the heavier hydrocarbons, constitutes an investment in the heavier hydrocarbons in place sufficient to establish its economic interest.

Cycling is a production process for (a) liquefying and recovering some of the heavier hydrocarbon compounds of natural gas in a gas stratum, and (b) the production of a substantial quantity of such compounds which otherwise would be irretrievably lost in the reservoir by retrograde condensation. The cycling industry is new, having experienced the material part of its growth and development since the year 1940, and being the only means whereby under the Texas conservation statutes the heavier hydrocarbons contained in gas from a gas stratum can be produced when the residue or the lighter compound of methane comprising about 94% of the volume of the gas is not then utilized for one of the statute enumerated purposes.[1]

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[1] For a comprehensive article on the history and problems involved in cycling gas in gas fields see article "Legal Problems Involved in Cycling Gas in Gas Fields" by H. P. Prossler, II 24 Texas Law Review 19.

That today in some fields cycling is required and that the return of the residue gas is essential to the recovery of hydrocarbons is recognized by Leland E. Fiske in his current book on Federal Taxation of Oil and Gas Transactions when in Section 8.05 thereof he says:

> "The operation of fields producing a very rich wet gas, known as distillate fields, requires the construction of a cycling plant.
>
> "* * *
>
> "The reason for returning the gas to the sand is to aid in recovery. If the pressure is maintained in the reservoir, all of the distillate remains in a gaseous phase, and will be swept forward to the well; but if the pressure is allowed to drop due to withdrawal of gas without reinjection, a part of the distillate will condense into a liquid and will adhere to the sand pores and be unrecoverable."

The mineral produced in the La Gloria case, the 6% of the volume of the gas in the high pressure gas reservoirs, consists of the heavier hydrocarbon compounds of ethanes, propanes, butanes, hexanes, and heptanes and heavier compounds which exist in a natural state and in a vapor state in the reservoir. As noted above such heavier hydrocarbons could only be produced under the conservation laws of Texas by the cycling process with the 94% of the volume of the gas being returned to and injected in the horizon from which it is produced. La Gloria played a vital essential role in the production of the heavier hydrocarbons. La Gloria contributed facilities necessary and indispensible to such production. La Gloria was engaged in production. Its facilities, its contributions, its operations of its cycling facilities pursuant to Special Order issued to it by the Railroad Commission of Texas (R. 218) were necessary

before there could be any production whatsoever of any hydrocarbon compound.

The mineral produced in the Bankline case was crude oil and casinghead gas, the latter being gas or vapor indigenous to an oil stratum and produced from such stratum with crude oil. Bankline took no part in the production of the casinghead gas. Bankline contributed no facility essential to such production. This casinghead gas could and was lawfully produced under the laws of the State of California irrespective of the utilization of the casinghead gas and irrespective of whether any heavier hydrocarbon would ever be extracted therefrom. The oil producers sold the casinghead gas to Bankline at the mouth of the wells. Bankline operated a gasoline plant and extracted some of the heavier hydrocarbons. Under Section 10 of the casinghead gas purchase contract "Bankline agreed to return to the Producer *at the property line* nearest to the existing dry lines of Bankline as much of the residue dry gas credited to Producer as may be necessary for fuel purposes and other producing activities of Producer on the premises, provided Bankline is not obligated to deliver at a pressure exceeding 20 lbs. at the plant of Bankline." The Producers did inject some residue gas in some oil wells to cause continued production of crude oil; but Bankline did not compress, Bankline did not deliver the residue to the producing wells, and Bankline did not inject the gas. In fact in the oil fields involved in the Bankline case no gas was injected into any gas stratum for the purpose of displacing wet gas and forcing the migration of the wet gas toward the producing wells; and no gas was injected into any gas stratum for the purpose of preventing retrograde condensation and producing quantities of the heavier hydrocarbons which would

otherwise have been irretrievably lost. There was no gas cycling in Bankline.

The distinction between Bankline and La Gloria is vital. Bankline was not engaged in production. La Gloria was engaged in production. There would have been production of oil and casinghead gas from the field in Bankline irrespective of whether Bankline or anyone else ever extracted the gasoline content of the casinghead gas. There would have been no production of the gas or the heavier hydrocarbons whatsoever from the field in La Gloria without the existence of the necessary and indispensible contributions made by La Gloria. Bankline contributed no essential facility to production. La Gloria contributed (and operated) facilities necessary and indispensable to production. Neither in a real nor in a legal sense is La Gloria conceptually close or similar in any material respect to Bankline. Southwest Exploration not Bankline is the controlling precedent for the La Gloria case.

Conclusion

For the reasons set forth above and in the petition for a writ of certiorari, it is respectfully urged that rehearing be granted and that, upon such rehearing, a writ of certiorari issue to the United States Court of Appeals for the Fifth Circuit. This case is of vital importance to the natural gas industry and to numerous parties who have and will enter into intricate multiparty transactions for the production of hydrocarbon compounds from high pressure gas reservoirs by means of cycling. It is likewise of vital importance in the administration of the Revenue Laws. The question presented warrants the time, the

analysis, and the judicial pronouncements of The Supreme Court of the United States.

Respectfully submitted,

BINFORD ARNEY
721 Wilson Tower
Corpus Christi, Texas

TARLTON MORROW
CLYDE L. WILSON, JR.
VINSON, ELKINS, WEEMS
& SEARLS
Esperson Building
Houston 2, Texas
Attorneys for Petitioners

Certificate of Counsel

I hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and is restricted to grounds specified in Rule 58 of the rules of this Court.

Attorney for Petitioners

Certificate of Service

I hereby certify that I have served copies of the foregoing Petition for Rehearing of Order Denying Petition for Writ of Certiorari on the Respondent, Frank Scofield, Formerly Collector of Internal Revenue, First District of Texas, by my depositing two copies of said Petition for Rehearing in the United States Post Office in Hous-

ton, Texas, enclosed in an envelope duly addressed to J. Lee Rankin, Solicitor General of the United States, Department of Justice, Washington, 25, D. C., with air mail postage fully prepaid, on the _____ day of January, 1960, and by my depositing two copies of said Petition for Rehearing in the United States Post Office in Houston, Texas, enclosed in an envelope duly addressed to Charles K. Rice, Assistant Attorney General, Department of Justice, Washington 25, D. C., with air mail postage fully prepaid, on the _____ day of January, 1960.

_____

Attorney for Petitioners